CHAPTER 19
RUSSIA

Introduction. Russia's economy is moving in the right direction. President Putin has a coherent economic strategy, which in turn is enhancing an impressive economic performance in a difficult global context.

- In just three years, President Putin has orchestrated a textbook economic turnaround.
- Back in 1998 the Russian economy hit rock bottom.
- Today, the Russian economy is an island of strong economic growth—albeit from a very low base—in a sea of global slowdown.
- Now comes the hard part: sustaining this economic growth, reducing poverty, and increasing economic security.
- The economic, social, and political challenges in the years ahead are daunting.

From Rock Bottom

But before we look at President Putin's economic turnaround, we need to appreciate just how bad things were before President Putin became president. The economic record of post-Communist Russia made depressing reading up through 1998:

- Output fell by 40% in real terms between 1989 and 1998.
- Inflation soared.
- Crisis followed crisis until the economy could not be patched up anymore.

Poor Country. To make matters worse, Russia was in bad shape when the crisis began. The crisis just deepened the malaise.

- Russia lags behind the wealthy Western economies by just about every conceivable yardstick.
- While a middle class is growing in Moscow and St. Petersburg, Russia's 145M people are in many ways provincial and isolated.
- In fact, 35% of all Russian people live below the poverty line.
- Per capita GDP in Russia is scarcely more than $2,000.
- The average annual wage is about $1,000.

Figure 19-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	394.9	337.9	332.5	251.1
Purchasing Power	631.0	580.3	928.8	1222.0
Real Growth (%)	0.9	-4.9	5.4	8.3
Inflation (%)	14.7	27.8	85.7	20.8
Exports	104.3	88.1	85.3	105.6
To U.S.	4.5	6.0	6.1	7.8
Imports	102.4	86.7	65.0	44.8
From U.S.	3.3	3.6	2.2	2.3
FDI from U.S.	1.4	0.6	0.8	0.6
In U.S.	0.2	..	0.1	0.1
Cur Account /GDP %	..	-1.6	11.8	18.0
Fiscal Balance /GDP %	..	-5.9	-4.4	1.0
External Debt /GDP %	30.5	66.8	46.9	..

Sources: IMF, World Bank, U.S. Commerce, Bank of Russia

Live By Oil, Die by Oil. These crises are nothing new in Soviet and Russian history. A key factor driving Russian crises in the past—and arguably its economic fate—is the price of oil, which is determined abroad.

- The collapse of oil prices in 1986 has played a key part in the subsequent unraveling of the Soviet economy, and later on, of the Soviet Union.
- Russian taxpayers are still suffering the economic consequences of that oil shock.
- The massive debts incurred between 1986 and 1990 to compensate for falling oil income will be a burden on the Russian budget for years to come, limiting the state's ability to respond more effectively to urgent social and other needs.

Default and Devaluation. Likewise, there is little doubt that declining oil revenues helped bring on Russia's 1998 default and devaluation.

- Starting in 1989, as the investment-starved Soviet economy effectively imploded, Russian oil production declined for ten straight years.
- When the government defaulted on its debt, Russian banks refused to perform on their forward ruble contracts.
- When the ruble was allowed to float, it nose-dived to near worthlessness.
- Foreign investors—exposed to the ruble with foreign exchange contracts in the Russian debt market—were soon jolted.

Global Crisis. Russia's devaluation and debt default set off financial shock waves.

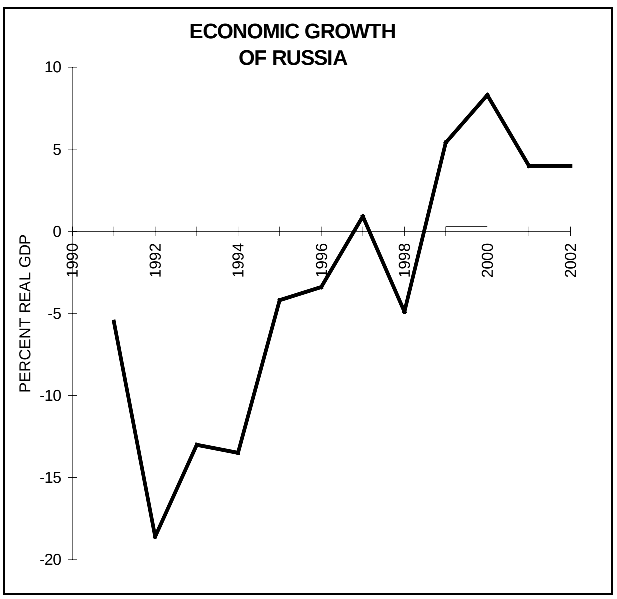
- On Wall Street, violent movements in North American stock and bond markets ensued, climaxing with the dramatic collapse of the LTCM bank in the United States.
- The world plunged into the worst financial crisis since the Great Depression.
- Thankfully, a massive injection of liquidity from the Fed averted disaster.

Bounce-back

Painful memories of the August 1998 financial crisis faded away faster than many expected. While economic problems still persist, Russia's problems today pale beside those of just three years ago.

- Russia is into its third successive year of economic expansion. (See Figure 19-B.)
- Economic growth in 1999 reached 8.3%.
- The Russian economic growth rate in 2002 is expected to slacken by one-half due to reduced global demand and the 9-11 attacks.[1]

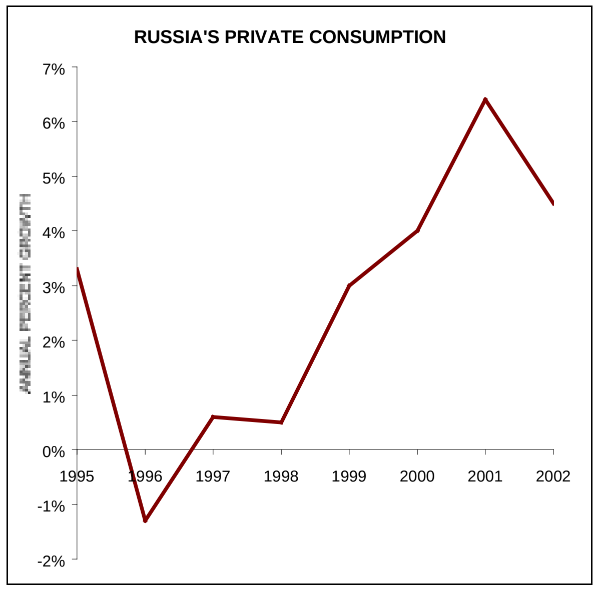
Figure 19-B



Russian Investment and Consumption Up. In addition, business and consumer spending are both up: (See Figure 19-C.)

- Retail sales went up 11.3% in September 2001 compared with September 2000 and 11.1% for a rolling average over the three months of July to September 2001.
- Similarly, fixed investment spending in September rose 9.5% year-on-year—the highest monthly increase since the start of 2001—and was up 8.6% on a three-month average.
- The numbers support impressions visible to one and all at street level. New shops, restaurants and cafes keep opening up in Moscow and St. Petersburg.
- Building renovation and construction is on the rise. This growth in construction spending reflects investor willingness to make medium and long-term commitments.

Figure 19-C



Shielded from Globalization. Manufacturing is also holding up well, with growth in July 2001 at its strongest in nine months.

- The relative isolation of the Russian market has helped insulate industry against the lion share of the global downturn of 2001.
- Russian companies sell to other Russian firms.
- Russia's only big long-distance exports are oil and gas to Europe and weaponry to countries such as China and India.

Rising Western Investment. But even in the oil business, Russia is bucking the tide of global pessimism. For instance:

- On 29 October 2001, Exxon announced the go ahead for a $12B project with Japanese, Indian, and Russian partners in the Russian Far East.
- This Exxon oil deal will be the single largest foreign investment in Russia.
- This Exxon oil deal also paves the way to clear outstanding obstacles in the development of two other production sharing agreements—at Sakhalin 2 with Shell and in Kharayhiaga in northwest Russia with Total.

Information Technology (IT) Rising. Similarly, at a time when the rest of the world is seeing deep contraction in IT business, Russia is once again bucking the tide.

- With a 15% rate of annual growth, the Russian information technology business is expanding nearly three times faster than the economy as a whole.

Pre-payment to IMF. Russia is even repaying its financial obligations to IMF early.

- In October 2001 Russia prepaid a $350M installment on an IMF loan due in 2003.
- IMF exposure to Russia is now only about $10B, or just half that of its peak.

Capital Flight Declines. Although capital flight is still high, it has continued to decline.

- Only 900M a month of capital left Russia in 3Q01.
- That's much lower than either the 1.4B a month in capital flight in 2Q01 or the 1.9B in capital flight in 3Q00.
- This decline in capital flight is a sign of confidence by Russians themselves.

International Finance Corporation (IFC) Thumbs Up. In addition, the IFC recently gave a few Russian banks a vote of confidence.

- In October 2002 the IFC indicated that it had plans to lend over $10M to four purely Russian banks and to examine business with companies in other sectors.
- Previously, the IFC has normally only lent to foreign companies doing business in Russia or to Russian firms with foreign guarantees.

Fading Kleptocracy. In the past, a corrupt Russian business climate scared off investors. While elements of the post-Soviet kleptocracy are still visible, the business climate is improving.

- Although the mob still exists, gangland slayings—a fairly common occurrence in the early 1990s—seldom take place these days.
- And while Russian corporate leaders still resort to bribery, a growing number of companies are succeeding through savvy management and high quality products.
- For instance, Moscow based juicemaker Wimm-Bill-Dann now exports to the United States, Europe, and the Middle East.
- Attentive investors like Boeing Aircraft also see significant change in Russia's business climate and are planning fresh commitments.

Key Question: How did Putin orchestrate this economic transformation?

<u>New Political Clout</u>. Putin has enjoyed sufficient political clout in the Duma to push economic reform legislation.

- Putin also enjoys 70% public approval and looks to be a sure bet for a second four-year Kremlin term.
- Putin seized the political moment and pushed through economic reform. (More on this later in the paper).

Economic Drivers

On the economic front, three drivers have given the Russian economy a big boost.

- The currency devaluation.
- Oil wealth.
- Structural reform.

Currency Devaluation. Russia's currency devaluation and the debt default in 1998 were blessings in disguise. After reaching rock-bottom, the Russian economy had only one way to go—and it has been heading higher ever since.

- The collapse of the ruble in 1998 helped trigger the current recovery.
- The ruble slid from 6 to more than 20 against the dollar when the government

defaulted on domestic bonds and froze foreign commercial debt.

- That gave Russia a much lower ruble cost-base, at a time when dollar prices for its main export, oil, were rising sharply.
- In short, the currency devaluation improved Russia's competitiveness and therefore its attraction to foreign investors.

Oil Wealth. The sharp rise in oil prices of 1999 and 2000 helped to boost revenues for Russian oil exporters. But a booming Russian oil industry reflects much more than just higher oil prices.

Improving Oil Productivity***.*** Russian oil companies are getting smarter.

- In 2000, oil output rose 5% thanks to $5B in capital investments. In 2001, oil output is projected to climb by 7.5%.
- The smartest Russian oil companies, such as privately held Tyumen Oil, are turning to Western energy service companies for a boost. Since 1998, Tyumen's pre-tax profits have doubled and are expected to reach $1.4B in 2001.
- Since 1998, Russian oil producers have gone from not knowing what was depleted in a field to having production software that gives them real-time information at each wellhead.

Oil's Positive Impact. The recovery of oil prices in 1999 and 2000 transformed Russia's current account and public finances.

- Investment spending began to pick up.
- Consumers started to spend again.
- And in contrast with industrial collapse in 1990s, industrial output also picked up.

Structural Reform. While President Putin has been lucky to benefit from this more positive economic environment since he was elected in the spring of 2000, the devaluation and higher oil prices were necessary but not sufficient factors for recovery.

- Economic reform was essential for recovery.
- With no more excuses and no other options to try, the 1998 crisis forced the government to start to create the conditions for economic growth.
- In fact, Putin's administration has pushed ahead with significant economic reform.

Flat Tax***.*** In a supply-side plan more radical than anything undertaken by President Reagan, Russia substituted a 13% flat rate tax on personal income for a complicated system that many people evaded.

- Smart move. It improved collection rates and removed many distortions.
- Personal income tax collection rose by 50% for the first half of 2001.
- Russia's economy will also get another supply-side boost from a cut in the corporate tax from 35% to 24%.
- When this corporate tax cut takes effect on 1 January 2002, Russia will have one of the most benign tax environments in Europe.

Other Reforms. The Putin administration has also implemented a number of other economic reforms that enhance long term economic growth:

- Fiscal Responsibility***.*** Russia’s public finances are now solid. Sound fiscal management has given Russia a large budget surplus.
- Better Governance. President Putin's new command over the central government has improved corporate governance: the rule of law has forced Russian companies to stop simply stealing from shareholders or bankers.

Unfinished Agenda

While Putin deserves credit for pushing a number of economic reforms through parliament, much remains to be done.

Weak Rule of Law. Russia still lacks an efficient judicial system. A strong rule of law is needed to:

- Strengthen property rights;
- Protect small investors and foreign investors;
- Improve corporate governance;
- Reverse capital flight by improving the business environment in Russia.

Legal reform, crucial to a well-run economy as well as an orderly society, is underway, but will take years, if not decades.

Restructuring of Energy Monopolies. Russia also needs to reform the national monopolies and create genuine competition.

- In this regard, there are schemes afoot to introduce more competition into the gas and electric markets and introduce more transparency into rail tariffs.
- The big dilemma is whether the government can take the political risk of removing government subsidies.
- In the short run, that would mean letting gas and electricity prices move higher and closer to market levels.
- In the long run, a new free market would encourage more competition and provides incentives for new private investment and new suppliers to enter the market.

Weak Banking System. Russia also lacks and a reliable commercial banking system.

- Reform of the financial system, dominated by state banks, has hardly started.
- Therefore, serious bank reform is a long way off.

Weak Government. The Russian government has also failed to complete the difficult transition to good governance. Infighting tends to turn almost any reform into a power-struggle.

Education and Health Care Systems. Both are essential for long term economic growth. Unfortunately, both systems remain weak and on the back burner for policy consideration.

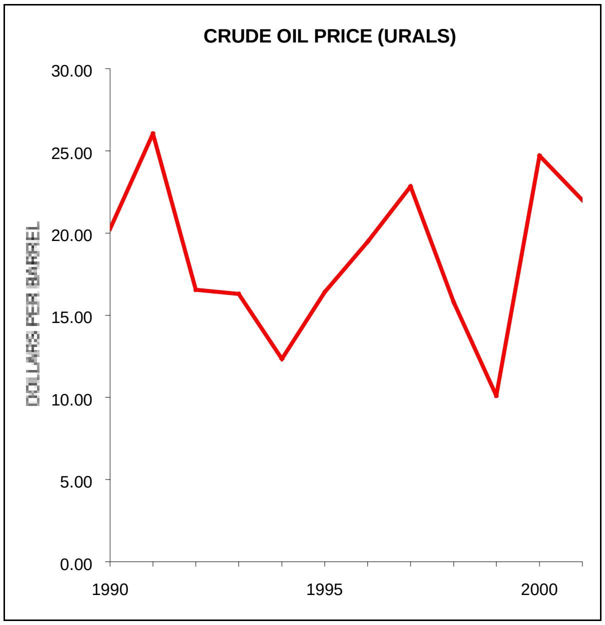
Oil

High Oil Prices: Slip-Sliding Away. Despite economic growth, the boost from the spike-up in oil prices is starting to lose its punch.

<u>Weaker Oil Prices.</u> The oil price spike-up is starting to wear off. That's a major concern because both the economy and government tax revenues remain dangerously dependent on the oil industry.

- Energy sales directly account for 16% of GDP and a third of federal budget revenues, sustaining equipment suppliers and providing income for the nation's banks, law, and advertising firms, retail outlets, and restaurants.

Figure 19-D



<u>Oil: A "Goldilocks Commodity</u>." Oil is a lot like Goldilocks' porridge, which could never be too hot or too cold. (See Figure 19-D.)

- Similarly, the Russian economy is in trouble if the price of oil goes too high or too low.

Goldilocks' Key Questions: What is the optimum price for Russia's oil? And why is there an optimum price?

- <u>Optimum Price</u>. A price of oil of about $22 a barrel for Urals blend oil will suit Russia nicely.
- <u>Not too High: Inflation</u>. At more than $22 and capital inflows will force Russia's inflation rate—already too high at 18% for 2001—even higher, push up the real exchange rate of the ruble even faster, and choke off growth in the rest of the economy.
- <u>Not too Low: Debt Service</u>. On the other hand, with the price of oil falling much below $22, as it has since 11 September, the international capital markets will begin to doubt Russia's capacity to service its large foreign debt obligations.

- A quick rule of thumb for Russian oil: Every $5 drop in the price of crude costs Russia about 1% of GDP. If the oil price drops to $15 a barrel or less, this shock will hammer economic growth.
- Russia says it can manage debt servicing unaided with an oil price as low as $17 a barrel.
- But if worries set in among lenders, Russian companies will have little hope of raising the long-term international finance they need for investment.

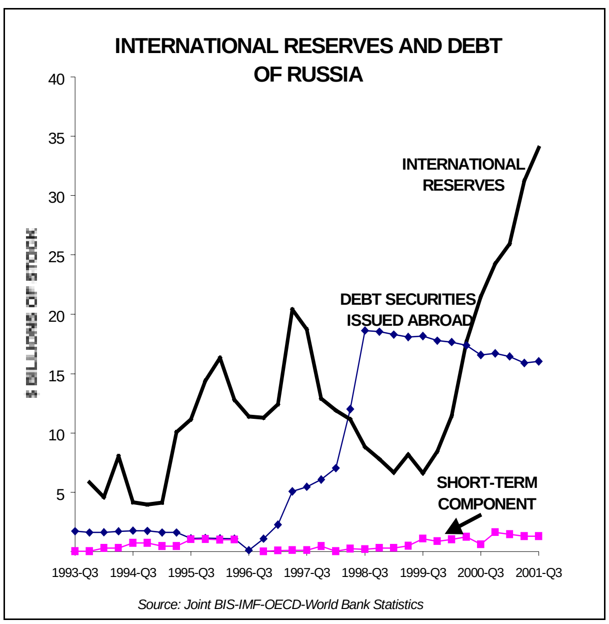
The Russian economic revival, therefore, hinges on oil prices remaining steady.

Stabilizing Oil: How can Russia maintain oil as a Goldilocks commodity at $22 a barrel as an optimum price for oil?

Option One: Russia and other non-OPEC countries can mirror OPEC and cut oil production when the price of oil goes too low, as is the case in December 2001.

- In fact, in early December 2001 Russia agreed to OPEC urgings and agreed to cut 5% of its oil production (150,000 barrels of crude oil a day).[2]

Figure 19-E



Fallacy of Managing Oil Production. Attempts to micro-manage oil production generally fail.

- First, if the price is too low, Russia has no control over the size of the cuts of other oil producers.
- Second, if the price is too high, there are production limits for oil producers.
- Third, oil producers generally respond too late to macroeconomic demands for oil.

Option Two: Stabilization Fund. Does this mean we should leave the price of oil almost totally to chance and the free market?

- No. OPEC will never let unfettered free markets govern oil prices.
- But in recent years OPEC has been unable to micromanage an optimum price.
- A better approach is for Russia to set up a stabilization fund.
- How does this work?
- A stabilization fund is a government fund that smoothes short-term fluctuations in oil and gas revenues.

Norwegian Stabilization Fund. The Norwegian government started collecting revenues for its fund in 1996.[3]

- By June 2001, the fund had accumulated assets with a market value of about $600B or 35% of its GDP.

A Russian Stabilization Fund. Moscow would benefit even more than Norway from such a fund.

- Russia is far more dependent on its oil commodity exports than Norway.
- Russia has a more vulnerable private economy.
- The volatility of Russia's oil industry has triggered crisis-after-crisis. So this vehicle to smooth short-term fluctuations in oil and gas revenues would be encouraging to investors.
- Russia could launch an energy stabilization fund with some of the large budget surplus accumulated in 2001.

Taming Overvalued Ruble. A Russian Stabilization Fund, if carefully implemented, would also help Moscow manage its foreign exchange problems.

- Let's look first at the looming foreign exchange rate problem Moscow faces.
- Then let's see how a Russian Stabilization Fund would work to curb the over-valued exchange rate of the ruble.

Devaluation: Slip-Sliding Away. The current economic growth due to the boost from the huge devaluation of 1998 is starting to lose its punch.

- Russia is starting to suffer from the "Dutch Disease" in which abundant export revenues from one sector (Russia's energy sector) cause a currency to become overvalued, thus rendering other export sectors over-priced and uncompetitive.
- In other words, Russia's large current account surplus has boosted ruble balances, put upward pressure on prices, and complicated exchange rate management.
- The ruble's nominal exchange rate has held firm, meaning a strong appreciation in real terms against the U.S. dollar.
- That real appreciation has already reduced the competitive advantage Russian industry gained in 1998 by 50%.
- So all exports are increasingly less attractive.
- By the end of 2002 most of the price advantages gained from the 1998 devaluation will totally disappear.

Avoiding Dutch Disease. Now let's see how a Russian Stabilization Fund would work to curb the over-valued exchange rate of the ruble.

- Once again, the Norwegian stabilization model provides the solution.
- All the Norwegian stabilization funds are invested overseas.
- In this way, Russia's abundant export revenues would be unable to overvalue the currency and unable to render Russia's other exports uncompetitive.
- Thus, a Russian stabilization fund would play a key role in Russia's macro-economic management, thus protecting the economy from the adverse effects of high oil revenues.

The 2003 Problem

In addition, Moscow is trying to create a sense of urgency with what it calls the 2003 problem.

- By 2003 the country's power stations, bridges, railways, and so forth will start conking out. In much of provincial Russia, this decline seems to have started to nose-dive some time ago.
- The outworn Soviet era infrastructure is a severe drag on Soviet growth prospects.
- Over the next quarter century the Soviets may need up to $2.5 trillion to replace the old infrastructure with a state of the art infrastructure foundation needed to compete with Western economies.

"Nuclear" Swords into Plowshares. Putin is well aware of Russia's infrastructure shortcomings and is putting a plan in place to address how to finance these needs.

- Putin and President Bush have tentatively agreed to dramatically curtail the number of nuclear warheads maintained by the United States and Russia.
- Maintaining the nuclear arsenal at present levels is a huge opportunity cost for the economy.
- The nuclear cutbacks could save billions for the needed improvements in other infrastructure.

Looking West. In this regard, Putin is strengthening ties to the United States in a broad and urgently needed modernization—not just of its battered army but also its economy, schools, and legal institutions.

- On 25 October 2001, U.S. Secretary of State Colin Powell underscored this same point with the Senate Foreign Relations Committee: "It is clear that that President Putin understands that Russia's future lies primarily in the West."
- In this regard, the events of 11 September may well be a turning point for how Moscow views Washington and U.S.-Russian relations.

"Partnership and One Civilization." For years, Russia was torn between its Slavic traditions and Western culture. Not anymore. President Putin has sided with the West.

- On 21 October 2001 at a news conference with President Bush in Shanghai, Putin said, “Our priority is partnership, a partnership based on the common values of one civilization."
- Partnership with the Western civilization means integration into Western-led institutions including NATO and WTO.
- Putin hopes to convince investors that the way to keep money flowing is to continue advances in corporate governance and transparency.

Not a Basket Case. One factor that could solidify a U.S.-Russian partnership is Russia’s new found economic strength.

- Russia is no longer the economic basket case it was in the Yeltsin era.
- Russia is flush with export revenues from oil, gas, and other commodities.

WTO Entry. To strengthen Russian ties to the West, President Putin is also pushing for Russia to follow China's lead and enter the WTO. But that remains a doubly controversial aim.

- Other WTO states think it may be a long time before Russia can match the international standards and practices required in the WTO.
- And many Russian companies want to put off WTO entry for fear that imports would wipe them out if tariff barriers were lowered.

U.S. Economic Interest. The improving U.S.-Russian relationship is also beneficial to U.S. national interests. In fact, Russia is also important to Washington in a way that hasn't been true since World War II.

- Russia's territory is vital for the U.S.-led war on terrorism. It stretches from the Sea of Japan to the Gulf of Finland. Iran is just across the Caspian Sea. The KGB and its successor agencies have monitored the activities of Islamic groups on Russia's borders for years.
- Russia is also a valuable source for crude oil should U.S. relations with Saudi Arabia deteriorate. Pumping seven million barrels a day, Russia is second only to the Saudis in oil production.
- Greater political consensus between the United States and Russia may also boost the chances for cooperation in building a pipeline from the oil-rich Caspian Sea to the West. BP, main developer of the proposed pipeline from the Caspian port of Baku to Ceyhan in Turkey, is huddling with Russia's Lukoil over possible participation.

Conclusions

After hitting rock bottom in 1998, the Russian economy is back on track. Russia is into its third consecutive year of economic expansion. Three drivers have given the economy a big boost: a currency devaluation, oil wealth, and structural reform.

The currency devaluation proved to be a blessing in disguise. It improved competitiveness, thus boosting Russian exports. The sharp rise in oil prices of 1999 and 2000 helped to boost revenues for oil exporters. And thanks to large capital investments, oil output rose sharply in 2000 and 2001.

President Putin's structural reforms have also been essential for the economic turnaround. In particular, a flat tax on personal income has boosted tax collection. A cut in the corporate tax rate in January 2002 will give Russia one of the most benign tax environments in Europe.

That said, President Putin has a difficult, unfinished agenda. Russia still lacks a rule of law. Energy monopolies need to be restructured. Reform of the banking system has hardly started.

In addition, two of Russia's economic drivers—the devaluation and high oil prices—are starting to lose their punch. The current $18 a barrel price of oil is moving steadily away from Russia's $22 a barrel optimum price for oil.

Since Russia's economic revival hinges on oil prices remaining steadier, Moscow should consider a stabilization fund similar to that used by Norway to smooth short-term fluctuations in oil and gas revenues. Investing the funds overseas would avoid the "Dutch disease" of strong exports over-valuing the ruble exchange rate.

In addition, Russia must address the "2003 problem," in which much of the country's infrastructure will wear out. A promising way to finance replacing this crumbling infrastructure is to work with the United States to dismantle much of the Cold War nuclear arsenal, thus transforming nuclear swords into plowshares. Enhancing the U.S.-Russian economic relationship will therefore be an important element in helping President Putin orchestrate the economic transformation of Russia's economy.

Endnote

---

1 Generally speaking, the terrorist attacks on 11 September 2001 had little direct impact on the Russian economy. The one exception was the Russian stock and bond markets, which fell in Russia as they did in many other areas of the world.

2 Russia's so-called 5% cut in oil production is more a virtual cut than a real one. It allows Russia to get maximum PR benefit with OPEC out of its "winter reality." Each year the impact of the severe Siberian winter weather leads to cuts in oil production levels. Similarly, logistical difficulties in shipping oil abroad from stormy and frozen ports lead to drops in oil exports. This winter reality generally equates to a 5% cut in oil production.

3 Augusto Lopez-Claros, "Bringing Stability to Russia," *Financial Times*, 18 December 2001.